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UNDER SECRETARY OF STATE
FOR ECONOMIC AFFAIRS
WASHINGTON

September 17, 1981

Cy:

Mr. Maurice Ernst
Director, Economic Research
Room 4F18
Central Intelligence Agency
Washington, DC

Dear Maurice,

Thank you for your memo of September 4 and the paper discussing the current status of West European-Soviet negotiations on the proposed Siberian pipeline. I appreciate your getting the report to us quickly.

I have attached some follow-up questions for your consideration. I look forward to hearing from you soon.

Sincerely,

Myer Rashish

Enclosure (SECRET)

Key Questions

1) The paper suggests that there will be cross-subsidization among the various aspects of the pipeline package deal; in particular that West European concessions on financing will be offset by inflated equipment prices and perhaps by concessionary energy prices. How will European banks, which will bear the cost of West European financial concessions, be compensated?

2) The paper states that the Soviets have scaled down their objectives for this round of negotiations to a single strand pipeline, and will seek a positive European decision on a second parallel strand two or three years hence. Have they dropped discussion of the second strand for the time being? Embassy contacts in Bonn report that the Soviets still seek a European decision on the whole two-strand project at this time, and that the Soviets are proposing contracts which would require the Europeans to purchase a minimum annual amount of gas in excess of the capacity of a single-strand pipeline.

3) The paper indicates that serious equipment contract negotiations are likely to follow agreement on financing and gas price and volumes. Reports from the field state that the Soviets are already bargaining with specific contractors, and that they could make key equipment purchase decisions as early as this month, prior to decisions on price and volume. Is there an inconsistency here?

4) The paper states that the Soviets and West Europeans will begin serious talks on gas price and volumes later this month. Have there been any discussions of this aspect of the deal to date, and if so, what are the likely terms of reference for further negotiations?

5) The paper asserts that the FRG commercial banks are offering credit (backed by Hermes) at 8 percent. Is this only a part of a larger package at market rates, which includes some interest costs in the price of the equipment?

6) Should the paper's assessment of the French Government as undecided on gas purchases be revised in light of recent conversations with Joelle Bourgois in Paris (Paris 26389)?

7) Was the Soviet-Italian agreement on $3.3 billion worth of contracts related to specific equipment purchases or to an open line of financing?

8) Should the assessment of prospective Japanese participation be updated in light of indications that the Government will provide EXIM Bank credits for pipeline compressors (Tokyo 16506)?

9) Is European skepticism about Algeria as an alternative related to technical as well as political factors?

10) The paper states that "both the private and government sectors of the Major West European countries are strongly in favor of the project." Are there any exceptions? Where are the weak links? Where is there room for U.S. initiatives?

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[redacted]

Question Two -- We do not believe that Moscow is pressing Western Europe for an immediate decision on a second pipeline. The Soviets have told potential suppliers of pipeline equipment that only one line is to be built for operation in the mid-1980s. Moscow has said that construction of a second line could begin before 1985, but the Soviets are not yet seeking formal agreements on such a project. The only apparent linkage made by Moscow between the first and second lines is a promise to give prospective compressor suppliers entering the lowest bid on the single line a first crack at orders for the second line when it does come up for negotiation. We have received no real evidence that the West Europeans are being urged to sign up for more gas than the single pipeline could deliver. [redacted] 25X1

Question Three -- Although some agreements on equipment sales could come before decisions on the quantity and price of gas deliveries are worked out, most supplier contracts probably will not be signed until after these decisions. Moscow will prefer to know what its hard currency revenues from the project will be before it commits itself to specific quantities and prices of pipeline equipment and services. A general contractor for the compressor stations may be signed up before October, but the Soviets will reserve the right to approve subcontractural agreements. Contracts for pipe deliveries will be made annually. [redacted]

Question Four -- The Soviets have held numerous discussions on gas prices and volumes with the West Europeans during the past few months, but hard bargaining on this issue has not yet occurred. Moscow reportedly is seeking a price in the range of \$5.50 - \$6.00 per million BTU, in line with the recently agreed price for Norwegian Statfjord gas. Although Moscow also is reported to have a bottom line price that approximates the price of residual oil (\$4.00 per million BTU), we have no evidence to indicate that the Soviets will be ready to compromise in the near future. They may be waiting for the outcome of Algerian price talks with France and Italy. [redacted] 25X1

[redacted] 25X1

Question Eight -- There has been no progress thus far on

[redacted]

Question Nine -- The West Europeans are aware of technical problems with Algerian LNG facilities, although we doubt that they are aware of the extent of technical difficulties facing Algeria in the production of the Hassi R'Mel gas field. None of the Algerian technical problems are insurmountable, however, and they could be quickly rectified if Algiers believes it has attained success in price negotiations or if it is forced to sell the gas to meet revenue needs. The main fear the West Europeans have is that Algeria may once again curtail gas deliveries over pricing or other disputes. [redacted] 25X1

Question Ten -- Support for the gas project in Western Europe appears to range from general acceptance of an apparently mutually beneficial business deal to strong support from exporters and governments. Some elements of the banking community remain skeptical of the profit potential, but practically no bankers appear truly concerned about increasing

Soviet debt exposure. In addition, no important opposition political parties have come out firmly against the project. The main concerns are about gas volumes and prices:

- To be competitive, the gas must be purchased at near the price of heavy fuel oil -- a price well below what the Soviets are currently trying to obtain.
- The West Europeans generally are basing their projected gas needs on forecasts that are around two years old. The forecasts do not take into account the marked slowdown in West European gas demand over the past 18 months or so -- a trend that may well continue. 25X1

The West Europeans regard the pipeline as their problem and have already demonstrated their resentment of US "interference." They see US opposition as driven by a self-centered and somewhat confused anti-Soviet campaign -- a campaign diluted considerably in West Europeans eyes by our decisions to lift the grain embargo and to approve the Caterpillar pipe-laying equipment contract. Further US pressure, particularly on political grounds, could thus be counterproductive. On the other hand, a well-defined, low-key campaign involving senior US Government officials and our Embassies in Western Europe could help stimulate, focus, and publicize the uncertainties concerning the market for Soviet gas in Europe. The fact that it is difficult to find enough room for the gas, that demand projections are likely to decline further, and that prices are softening also could be more pointedly discussed and more broadly publicized.

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With respect to alternative gas sources, the most relevant are Algeria, Nigeria, and Norway. A definite US withdrawal from the Algerian and Nigerian LNG markets would improve the West Europeans' bargaining positions with these countries. Although Algeria at least has not been regarded as a secure energy source, both that country and Nigeria will need the income from large additional gas sales badly, and will, in their own interests, have to accept reasonable terms. Beyond the 1980s, Norway is the only large nearby alternative supplier of additional gas for Western Europe. US influence on Norwegian gas policy is minimal, but the gas resources needed to fill West European needs are almost certainly there.

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